COMMON CARRIER BUREAU

memorandum

TO: **Magalie Roman Salas, Secretary**

FROM: **Johanna Mikes, Common Carrier Bureau**

SUBJECT: **Application of GTE Corporation and Bell Atlantic Corporation for Consent to Transfer of Control, CC Docket No. 98-184**

DATE: **April 19, 2000**

Please place the attached transcript on the public record for CC Docket No. 98-184. The transcript details a debate held before Commission staff on April 7, 2000, at which representatives from Bell Atlantic and GTE and representatives from AT&T discussed Bell Atlantic and GTE's proposal to spinoff GTE Internetworking and related assets into a separate public corporation to comply with section 271 of the Communications Act.

Please note that the transcript incorrectly identifies Steven G. Bradbury of Kirkland & Ellis as Steven G. Bradshaw.

ORIGINAL

UNITED STATES
FEDERAL COMMUNICATIONS COMMISSION

In Re Application of:)
)
BELL ATLANTIC and)
GTE)

Pages: 1 through 147

Place: Washington, DC

Date: April 7, 2000

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1220 L Street, N.W., Suite 600
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(202) 628-4888
hrc@concentric.net

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In Re Application of:	)
	)
BELL ATLANTIC and	)
GTE	)

Room B 516
FCC Building
445 12th Street, S.W.
Washington, D.C.

Friday,
April 7, 2000

The parties met, pursuant to notice, at 1:10 p.m.

APPEARANCES:

Panel 1
John C. Coffee
Columbia University

Peter D. Keisler
Sidley & Austin

Joan Marsh
AT&T

Panel 2
John Thorne
Bell Atlantic

Michael E. Glover
Bell Atlantic

Ronald J. Gilson
Stanford School of Law

William P. Barr
GTE

Panel 2 -- CONTINUE --

Steven G. Bradshaw
Kirkland & Ellis

Panel 3

Jim Bird
Federal Communications Commission

Bob Atkinson
Federal Communications Commission

Larry Strickling
Federal Communications Commission

Michelle Carey
Federal Communications Commission

Johana Mikes
Federal Communications Commission

Paula Silberthan
Federal Communications Commission

Dorothy Attwood
Federal Communications Commission

Darryl Cooper
Federal Communications Commission

P R O C E E D I N G S

(1:10 p.m.)

MR. LARRY STRICKLING: That, I think -- at least with the parties individually.

We had felt that there would be a big benefit to getting the experts in particular, but also the representatives of both sides, together to talk about the legal issue surrounding the proposed spinoff in more detail, when we can get a little more meeting of the issues, at least, if not a meeting of the minds in terms of the analysis that we should be undertaking as we analyze that; and just getting a sense of why we seem to have such disparate viewpoints about the evaluation of the proposal that Bell Atlantic-GTE has put before us.

I'll just introduce the folks that have come in, in the -- this is -- at some point, it's going to turn into a test, exactly when, I don't know. But I think everyone knows Dorothy Attwood from the Chairman's office. George introduced himself; Sarah Whitsall (phonetic) from Commissioner Costani's (phonetic) office; Rebecca Bainan (phonetic) from Commissioner Perchkot Roth's office.

(Informal comment.)

MR. STRICKLING: And Mike Jacobs in the back, from Policy Division.

So, I think we'll start by letting each side kind

of lay out its position. Take five or ten minutes, and divide the time up however you want. And, obviously, it was important to us to have the two experts here today, so we'd like to make sure you all have as much time to talk to us and interact with each other about these issues, but by no means are we limiting the discussion to the two of you. In other words, Peter, John and Steve, Bill, John, you're all welcome to pitch in while we're -- if you feel you need to.

So, we'll start with Bob and GTE.

MR. WILLIAM BARR: Okay. Thanks, Larry.

I'll just take a minute to lay out a -- or, a couple of minutes to lay out a overview of our position -- and then turn it over to Ron Gilson. Obviously, the Telecommunications Act says that a BOC can't own and operate an entity that provides in region, interlata. It further defines BOC as meaning to own an equity interest or any equivalent thereof of more than 10 percent. Now, under our proposal we will have a 10 percent interest, and we're going to have an option that would allow us in the future to apply a greater ownership.

The option is subject to a condition precedent, which is getting a sufficient 271 ruling. But I think a critical issue here is in which world are we operating. Are we operating in a world where the statute, on its face, dictates or mandates a particular conclusion that the option

is *per se* ownership or control, or is the Commission foreclosed from finding anything else? Is the Commission's hands tied on the face of the statute? Or, are we in a world that necessarily involves a degree of policy judgment and discretion by the Commission in effectuating the purposes of the Act?

Now, as to ownership, our view is that, under the plain terms of the statute under well-settled principles of law, an option is not ownership. It's not an equity interest; it's a contract right to acquire equity in the future. And in a host of contexts, Hart-Scott-Rodino; the FCC's own precedents and the MFJ precedents, it's been so held that it does not constitute -- options don't constitute ownership.

So, on the face of the statute, we say certainly it can't be concluded that we own -- that we would own, by virtue of this option, Genuity. And, on the contrary, we think it'd have to depart from the general principles of law and a substantial precedent to find otherwise.

Now, when you enter the realm of policy, we think it's evident that our proposal is consistent -- indeed, advances -- the policies of 271. And the issue there has to be what are the overall incentive. What's the net effect of this on the incentives under 271 -- and not to isolate, particular effects, but what does this do overall to our

incentives?

And we believe that having this very specific, unique opportunity and having made a big bet on it certainly provides us with a bigger carrot. It means a bigger stick -- the loss of this opportunity and the setting of a five-year limit, which other companies are not subject to. And we don't think that you can close your eyes to the nature of the business here and the fact that it poses very minimal risk of any discrimination because of the very nature of the business. And, certainly, our voluntary undertakings add another dimension and another level to the overall incentives.

As to control, we think control necessarily is a case-by-case decision that inherently involves policy judgment. And the inquiry is whether or not we would influence the day -- or control the day-to-day operations of this entity.

And when you look at the structure here, with the 90 percent public ownership and vote, an independent board -- and, incidentally, as we've made clear, we're willing to let the Commission review or anything else it wants to do on the directors -- these are people who have no prior affiliation or current affiliation with either company -- we have a real condition precedent here.

So, there's no imminence in the fact that the BOC

will be able to exercise its option. We have transparent arrangements policed by an independent auditor. And we think that the inquiry over control, although AT&T suggests that there's some kind of free-floating standard out there bereft of any context or any specific statutory concern.

In fact, the control inherently involves -- has to be -- the decision on control has to be informed by policy concerns that are at issue. And the question is, in a particular context, why are we worried about control. And that can differ. In foreign ownership, you may be worried about control for a particular reason. If the issue is diversity of programming, then you would be looking at certain levers and factors that go to the ability to influence programming. If you're worried about the diversity of the long-term ownership and structure of a industry, then you may be interested in other aspects. So, you can't divorce the issue of looking at -- on a case-by-case basis -- from the policy concerns of the statute.

And here, what the policy concern ultimately on control is, is whether or not the BOC would control the other entity in a way that it could garner the benefits of operating as one on two levels, essentially. And we -- nothing here suggests that there be any such control. And therefore it's no wonder that AT&T is sort of running away from the statute and looking for some other standard to apply.

With that, I'll just turn it over to Ron.

MR. RONALD J. GILSON: Let me start by thanking everyone for the compliment of thinking that I've got something to add to your deliberations. There's an awful lot of legal talent in this room without Jack and me. We -- I suspect we both appreciate the implicit compliment.

Much of my writing and teaching goes to understanding the basic economic structure of complex transactions like this one. And what it means is I work at the intersection of law, finance and economics. One of the very interesting things about this matter for me is to indeed discover that the FCC in this area and I operate in the same neighborhood. You're confronted in this transaction by the application of legal rules informed deeply by the economics and the finances.

I want to use my time to at least briefly make a small number of pretty straightforward points about how the issue is presented by the Bell Atlantic-GTE application layout. The first is simply that it's analytically proper to separate the option inherent in the Class B/ convertability of the Class B stock in assessing the application of section 31 and 271 to that transaction.

I'm well aware that counsel to AT&T has repeatedly characterized that analytical separation as a "thought experiment" and at times even less kindly. With due

respect, on this one counsel is simply wrong.

The separation, treating a convertible instrument as an underlying instrument and a separation option is not a matter of form. It's a separation that developed in the practical finance literature by traders who were interested in understanding the consequences and of each of those two -- each of those two instruments. Traders are the most practical of individuals. There's nothing formal about what they do, because markets value only substance.

So that ask for a moment what turns on that separation simply is a matter of analysis -- concern about form or concern about substance. We're pushing toward understanding the option as a separate instrument.

Perhaps the easiest way to make the point is I don't understand any of the arguments that AT&T has made with respect to this structure. Any of them would alter one iota if there's a formal matter, this was presented as two separate pieces of paper, or for other reasons it gets combined into a single instrument. The set of substantive issues that are involved are driven by a present equity interest and an option which turns into an equity interest at some future point. That is a substantive, not a formal, characterization.

That brings me to my second point, and that is that an option is not an equity interest under section 31.

It -- in virtually every body of law an option is recognized as providing future equity interest, not a current equity interest. The transformation takes place when it's converted.

Examples: An employee stock option; when my kid, who is in a -- has a bunch of these things -- not until she exercises that does she have anything -- does she have any interest in the corporation other than as an employee. She can't vote, she can't get dividends, she doesn't get a distribution, nobody has to send her any documents per corporate law. All -- she becomes the holder of stock when she provides them with their notice of exercise.

Other examples: Under Delaware corporate law, the holder of a convertible bond is not a stockholder, has no right to bring a derivative suit, is owed no fiduciary duty until the conversion is -- until the holder exercises that conversion right. Rights change when that conversion takes place.

Indeed, the Securities Exchange Act is the only prominent example of where an option is defined as an equity security, where the promise, the future right to a conversion to an equity interest, is treated as an equity security. I guess I want to make three, quick points with respect to the Securities Exchange Act. The first is simply that the Communications Act uses a different term. Security

is an equity interest, not an equity security.

More relevant is the fact that a Delaware chancery court, in considering, in effect, precisely this interest -- whether a conversion right -- whether the right to convert into an equity security ought to be treated as an equity security based on the precedent of the Securities Exchange Act definition, the court said no -- that for corporate law purposes it's the act of conversion that translates a future equity interest into a current equity interest.

Now, that's not because the Securities Exchange Act makes a mistake. For the purposes of the Securities Exchange Act, where the sale of an option raises the same issues of disclosure or fraud as the sale of the underlying stock treating the sale of an option as an equity interest for purposes of triggering disclosure and triggering insider trading obligations makes perfect sense. Taken out of that context, the statutory purpose dictates a different outcome. The Delaware chancery court actually put it in just this way when they said that the Securities Exchange Act definition is limited to the rationale of the Securities Exchange Act. The Securities Exchange Act is a different statute with different rationales, different statutory purposes than the Federal Communication Act.

Now, if we wanted to look for another statute whose structure would illuminate the Federal Communications

Act -- and, frankly, I'm not sure why it's so obvious that it's useful to go down that road. The Federal Communications Act is a coherent structure with a body of precedents that will match any other regulatory agency. But if we go down that road, it seems to me that the relevant analog isn't the Security Exchange Act, under which the shift between the promise and between the future equity interest and current equity interest makes no difference; but, rather, the Hart- Scott-Rodino Pre-merger Notification Act. Because an acquisition for anti-trust purposes -- and, to be sure, competition policy -- is a matter of some concern to the Federal Communications Commission, as well, an acquisition that triggers disclosure under Hart-Scott-Rodino doesn't occur when you buy a convertible interest. The regulations make explicit that the acquisition of a convertible interest is not an acquisition for purposes of the Act.

The regulations go on to provide that the conversion is treated as an acquisition under the Act. In that sense, Hart-Scott-Rodino's quite explicit distinction between a current equity interest and a future equity interest is structurally parallel to the Commission's structure under 271, where, in this matter, in order for Bell Atlantic to exercise its option, it first is to provide -- it first has to comply with section 271.

So that the Commission always has a second bite of the apple. Nothing turns as a matter of rights on the existence of the option. 271 has to be -- as I understand it -- has to be satisfied in connection with this exercise at a later date.

My third point is much shorter and goes to the issue of equity equivalent under the statute. The statute refers to an equity interest or its equivalent. Here I think the point is pretty straightforward. An equity interest is one that provides the same -- excuse me. An equity equivalent is something that provides the same rights as equity, except through another device.

I can write a contract that provides contractually the same set of rights to dividends, rights to voting, rights to redemption -- and do it by contract, rather than through a more familiar capital market interest, like a share of stock. The term "equity equivalent" takes that on. Something is an equity equivalent when the rights one gets through it are the same as one would get through an equity interest.

Now, this not at all remarkable equation between an equity interest and what it's equivalent becomes important only in the context of the debate that's been going on with respect to this matter where AT&T's position is that, if there is only a value equivalent -- that is, if

an option under some circumstances can provide the same value but not any of the other participatory rights -- that somehow that triggers -- that makes it an equity equivalent. That, again, I think, is straightforwardly wrong. I can duplicate any value equivalent, any change in value by going to a major investment bank and having them write a proprietary derivative which will give me appreciation rights that will track any formal instrument, without the company being involved at all. It allows me appreciation. It allows -- it is not an equity equivalent, because it provides none of the interests associated with equity.

Now, let me be clear. I don't mean to say that value isn't important. But the role of value comes up not in determining whether something is an equity equivalent, a conclusion which essentially removes any Commission discretion to take into account the purposes of the statute in evaluating a complex transaction. Rather, value comes up as one of the myriad of circumstances that the Commission will look at in the exercise of its experience and its discretion to determine whether the structure of a transaction presents indicia of control relevant to section 271 such that it would have control in light of the purposes of the statute and, in particular, section 271.

Now, that brings me to my last point. In my judgment, the arrangement here doesn't create control in any

fashion relevant to section 271. Functionally, the structure that's been created parallels in virtually every respect that which the Commission has seen over and over again in the context of approving acquisition transactions. Someone who has an executory interest under an acquisition agreement for all matters of substance holds an option on the right to by that company.

That option is saleable. That option comes with a set of protections. It is typically the case that there's a covenant covering, in a regulatory context, the often quite lengthy period between the time the option -- between the time the contract is executed and the time the contract closes following Commission approval.

That set of protections provided the acquiring company typically track and, indeed, typically are more extensive than the quite parallel set of protections that Bell Atlantic has with respect to -- Newco has with respect to in this transaction. And my declaration basically just laid the two sets of protections out, one next to each other. The protections provided Bell are less extensive than the protections that, for example, AT&T has in its Media One acquisition and with what I understand are the changes to those matters now proposed. The difference is even grander.

The only thing that alters that structure -- the

Bell Atlantic-GTE structure from the ones that you see every time you approve an acquisition are driven by the nature of section 271. There's a time difference. The period necessary to satisfy the regulatory requirements with respect to this transaction are understandably going to take longer than the time necessary to secure the regulatory approvals with respect to standard commission of an acquisition. But the reason for that is -- it doesn't have anything to do with Bell Atlantic's efforts to exercise control or anything else.

It relates to the time necessary to secure section 271 approval to generate competition in the series of local markets that -- for which approval is necessary. So that the structure is functionally identical, with the exception of a lengthier time period. But the lengthier time period drives from the -- derives directly from the nature of section 271 approval. And the set of protections build into a transaction guarantees that none of the concerns that the Commission addressed in Ameritech are possible under those circumstances under the control -- control as a matter of experience and discretion.

The need for the Commission to have the flexibility to deal with the kinds of transactions -- complex transactions that come up as this industry shifts its form dictates, when dealing with these matters under the

control element, where it has the discretion to take the statute into account. And then with respect to this particular transaction comes out just fine.

MR. BARR: GTE Internetworking has been named "Genuity." A lot of people wondered why we didn't name Newco "Newity".

(Laughter.)

MR. STRICKLING: Does anyone have any questions they want to pose at this point? Or, should we turn to AT&T? Panelists?

MAN: If it's okay, Larry, Professor Coffee will address these issues from general corporate law, and I'll talk about the cases.

PROF. JOHN C. COFFEE: I also want to thank you for the compliment of inviting us. And, humbly, I am probably the person in this room least learned in the Communications Act. I think I'm the only person in this room who doesn't purport to be an expert in it -- and I'm not that.

I am, however, very experienced in the concept of corporate control -- an area where I spent over 30 years as a practitioner, first, in Quebec, and as an academic for the last 25 years. And I think I'm very familiar with the approaches of various bodies of law -- not just the federal Securities Exchange Act, but other federal statutes -- the

Trust Indenture Act, the Investment Company Act, the Utility Holding Act -- state corporate law, which we'll talk about later; and other federal statutes, including the bankruptcy code -- all of which have had to address and deal with attempts to recharacterize equity interest in order to avoid substantive regulation. That's been a recurring theme for a variety of federal agencies and state courts and the tax law.

The underlying response of most agencies and courts in this setting has been to recognize the need -- the clear need -- to prevent circumvention of the agencies' authority -- in particular, by piercing through sham transactions; determining the actual, underlying, economic substance; and realistically assessing who actually possesses ownership and control. Ultimately, this has been more, in my judgment, a matter of sort of the political science of who has the power than simply financial economics, because we're concerned with the actual power and the actual, practical ability to realize the economic benefits of ownership.

In that light, my primary contention today is that you have before you in this case neither a traditional convertible security nor an option even if you to disaggregate things in any meaningful sense; but, rather, a transparent stock parking arrangement in which Bell Atlantic

and GTE are essentially playing a game under which they hide their true equity interest and power in -- from this agency, while displaying it fairly transparently to the market. Now, even if there are strong economic justifications for this transaction -- and there may be, and I have no position on that question -- the consequences of any agency accepting this easily, what I consider and will try argue is a sham transaction, are likely to haunt you for decades. And certainly they are going to invite transaction planners, who are very clever people -- both at AT&T and Bell Atlantic, and elsewhere -- to place similar-form substance games.

Even if you resist all those other efforts, you're going to be inundated by them, because this particular transaction is not a loophole; it's a triumphal arch, and it's going to invite many more. And you're going to find yourself deeply enmeshed in the problem of what do you do with options. Because once you say options are exempt, all kinds of other regulatory problems arise in terms of how you deal with value, with -- and otherwise recognize options.

My goal, then, today is to convince you that this particular end -- even if desirable -- should not justify this very costly means, which is a very broad exemption, in part because there are other techniques by which this transaction could be legitimately structured.

Now, why do I call this transaction a sham? Let

me count the ways. I'm going to go through a number of very similar points, and I invite you to follow up and ask me what I'm talking about if anything is a little opaque. First, this is not a classic option, because its exercise is costless, point one. It's costless. In any real-world option, the holder either pays a strike price or surrenders a senior security as the cost of conversion.

Here, there is no cash payment on exercise, and the Class B shares do not have materially different terms or different seniority than vis-a-vis the Class A shares. Here, one simply exchanges a 10 percent stake for an 80 percent stake at no cost. This is not a true, real economic exchange. It's similar to as if I had a one-dollar bill and the right at any time to exchange it into an eight-dollar bill -- or eight one-dollar bills. If you have that right, what you really have is the functional equivalent of eight one-dollar bills.

I don't think you can count this as the same kind of transaction that a real option reflects. What's really going on here is that the 70 percent difference between 10 percent and 80 percent is being temporarily parked in a kind of hidden, legal limbo which the Commission is being asked to treat as legally invisible. I think that asks you to wear blinders, and I think that's undesirable. Point one --

MR. STRICKLING: Professor, can I just ask a

question? Is there an example of a convertible interest exchange where it doesn't involve either the payment of additional consideration in cash or the surrender of some security with senior rights?

MR. COFFEE: I can't tell you that it's never been invented in the mind of man, but I'm talking about the real world of trends and markets and what is usually designed. And, usually, there is some surrender, some cash payment. We may come up with something, someplace, but I think the presumption is it's something is highly irregular and doesn't look like a standard option. In other words, even if you wanted to believe -- and I'll argue against this -- that options are not equity interest, this is not the kind of option that should be recognized as the kind of option that normally would be exempt. This is highly irregular.

So, we move from the first point, that this is a costless exercise, to the second point. This option is riskless. Compare it to any kind of option that you'll see in securities markets. Even in the most extreme case -- which I'll call the flow-market stock option, given to a corporate officer -- something the tax law calls a nonqualified stock option and thinks is a little -- means particularly high taxes -- even in the case of the nonqualified stock option at below-market prices when it's granted, there is still a risk that the market price can

fall below the option price. But whatever happens in the stock market -- and I believe anything can happen in the stock market -- the one thing that cannot happen in that the 80 percent of Data Co that will eventually be issued cannot fall in value below the 10 percent of Data Co that Bell Atlantic will currently own pursuant to the Class B shares. There's no way that 80 percent can be less than 10 percent.

Now, nor is there risk otherwise. There's no risk here because Bell Atlantic may not be able to secure FCC approval. In that event, it can either sell the Class B shares or convert to Class A and sell the Class A shares. I recognize that, under the recent modifications, Bell Atlantic has committed itself to surrender some of its gains, if it's unable to secure approval, to the U.S. Treasury. That's still not the same thing as a down-side risk. It is sacrificing only a portion of its up side gain. It is taking no down-side risk -- no risk of loss. If you could by an investment tomorrow under which you have no down side and the up side may be small or it may be great, it's got a positive present value. And I suggest if you get it at no cost, it's a very good thing to own -- because there is no down side, and there is an up side. The second point, then: No risk.

Third, well, Bell Atlantic is seeking to hide --

MR. STRICKLING: Wait, just -- I'm sorry to keep

interrupting you, but here is my thought process, which is that does -- even if there was risk, where risk would attach to this -- some down-side risk -- would that overcome the -- your first objection, which is the fact that the exercise of the option is costless? Or, would your argument be --

MR. COFFEE: No, I -- there are --

MR. STRICKLING: -- that the first characteristic of this -- is there something they could do with the risk equation that would overcome that first objection?

MR. COFFEE: If you can get something at no cost, then -- and exercise it so that it will always be worth more -- 10 percent, 80 percent -- I don't think that's anything that the world has seen as a normal option that trades in markets. I think that is, in effect, a simple deferral or parking of equity rights until after it becomes appropriate or legally permissible to recognize those equity rights and powers. Okay.

My third point: While Bell Atlantic is seeking to hide its equity value from the FCC in this proceeding, I think it's transparently broadcasted to the market, because Bell Atlantic has told the market through analyst reports -- and I have documentary copies of them here -- that it will take 80 percent of Data Co earnings on its own income statement. So, in accounting terms, there are two significants here. In accounting terms this means that if

you're going to take 80 percent of the earnings from Data Co on your own income statement, you have what accountants call a common stock equivalent -- a common stock equivalent equal to 80 percent of the outstanding stock of the company. That's a different kind of analogy. We're talking about securities laws, but I think the accountants also have a way of recognizing -- piercing through transactions and recognizing what is a stock equivalent.

I recognize there is some dispute as to whether these statements were actually made. It looks like securities analysts went to a regularly scheduled meeting and then voted, an executive vice president breaking the tie. I must say of all the people in this proceeding securities analysts are the most disinterested, and I suspect we can find there was more than one person there who heard these statements.

Now, even if this right to get 80 percent of the earnings on your income statement is later canceled, nullified, or whatever, in the meantime, it clearly shows control. Because if you have the ability to tell the investors in Bell Atlantic that you're going to take 80 percent of the earnings of this company onto your income statement, that means you've got control over the board of directors and know that you can control their ability to pay on dividends, and preclude them from paying on dividends.

And there's no way you can take 80 percent before even paying out 30, or 40, or 50 percent to the existing shareholders of the Class A security. Thus, I think you've got strong evidence of control over the board here, even apart from the common stock equivalents under accounting law.

Okay, fourth point: When courts and agencies have deferred options -- sometimes they have, and they've treated them as an independent reality -- there has always been a counter-party who negotiated the transaction at arm's length.

Please ask yourself this: Who did Bell Atlantic negotiate this option with? The answer is it negotiated with itself. There are similar cases. There's an analogy here. When the founder of a firm decides at the outset of the firm to contribute its capital in different forms -- say, part debt and part equity -- courts and agencies have long recognized a duty to recharacterize that contribution in line with the economic realities. Thus, in federal bankruptcy law, where there are hundreds of cases, the founder who capitalizes a firm with, say, 20 percent equity and 80 percent debt will on insolvency that the bankruptcy court is likely to treat much of that debt as constructive equity -- as an equity equivalent. This is called the Gay-Brock doctrine. It's a Supreme Court precedent, and there